# The Land Market and 1031 Exchanges

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| Market Report | Yr Ago | 4 Wks Ago | 8/12/05 |
|---|---|---|---|
| ***Livestock and Products, Weekly Average*** | | | |
| Nebraska Slaughter Steers, 35-65% Choice, Live Weight . . . . . . . . | $85.03 | $80.00 | $80.07 |
| Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb . . . . . | 139.33 | 142.21 | 145.00 |
| Nebraska Feeder Steers, Med. & Large Frame 750-800 lb . . . . . | 123.98 | 118.89 | 116.24 |
| Choice Boxed Beef, 600-750 lb. Carcass . . . . . . . . . . . . . . | 137.53 | 133.87 | 133.72 |
| Western Corn Belt Base Hog Price Carcass, Negotiated . . . . . . . . . . . . . | 74.46 | 66.21 | 67.70 |
| Feeder Pigs, National Direct 45 lbs, FOB . . . . . . . . . . . . . . . . . . . . . | 42.39 | 49.09 | 47.42 |
| Pork Carcass Cutout, 185 lb. Carcass, 51-52% Lean . . . . . . . . . . . . . . . . . . . . | 78.73 | 69.47 | 72.57 |
| Slaughter Lambs, Ch. & Pr., 90-160 lbs., Shorn, Midwest . . . . . . . . . . . . . . . . . . | 90.50 | 105.00 | 91.00 |
| National Carcass Lamb Cutout, FOB . . . . . . . . . . . . . . . . . . . . . . . . . . . | 216.83 | 250.87 | 250.13 |
| ***Crops, Daily Spot Prices*** | | | |
| Wheat, No. 1, H.W. Omaha, bu . . . . . . . . . . . . . . . . . . . . . . | 3.13 | 3.16 | 3.06 |
| Corn, No. 2, Yellow Omaha, bu . . . . . . . . . . . . . . . . . . . . . . | 2.18 | 2.14 | 1.78 |
| Soybeans, No. 1, Yellow Omaha, bu . . . . . . . . . . . . . . . . . . . . . . | 6.13 | 6.98 | 6.19 |
| Grain Sorghum, No. 2, Yellow Columbus, cwt . . . . . . . . . . . . . . . . . . | 3.11 | 3.66 | 3.04 |
| Oats, No. 2, Heavy Minneapolis, MN , bu . . . . . . . . . . . . . | 1.50 | 1.94 | 1.82 |
| ***Hay*** | | | |
| Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton . . . . . . . . . . . | 115.00 | 117.50 | 117.50 |
| Alfalfa, Large Rounds, Good Platte Valley, ton . . . . . . . . . . . . . . . . . | 62.50 | 37.50 | 37.50 |
| Grass Hay, Large Rounds, Good Northeast Nebraska, ton . . . . . . . . . . . | 57.50 | 52.50 | 52.50 |

* No market.

Nebraska agricultural land values have increased nearly 50 percent in the past decade. To many observers this increase is much greater than would be expected based on crop profitability. Increasingly it is mentioned that the Section 1031 Exchange provision of the Internal Revenue Code is an important element leading to increased land values. This provision provides for tax deferral of the capital gain tax if an exchange occurs with like-kind property. The 1031 provision was enacted in 1984 by limiting the scope of the Starker Court decision of 1979. In 1991 IRS issued regulations regarding procedures of 1031 Exchanges. Section 1031 Exchanges have become so popular that the tax deferral aspects are commonly viewed as having a major tax sheltering-upward impact on land values.

It is important to understand that all investments involve varying proportions of annual returns (dividends) and long-run appreciation (growth). One extreme is holding cash which involves no annual return but also no growth (negative real growth under inflation). The other extreme is a growth asset which yields no dividends. Falling between these extremes are CDs, Treasuries, real estate, securities, etc. Dividends are taxed at an ordinary income tax rate while capital appreciation is taxed at 15 percent. Also, capital appreciation tax is only paid at the time of the asset sale, not periodically. We can term the favorable tax provisions for capital appreciation as "tax shelters." In the long-run, because farmland increases in nominal value, it is an asset which generally receives these tax shelter advantages. However, in addition a 1031 Exchange allows the further deferral of capital appreciation tax at the time of the sale provided a like-kind purchase is made. Thus, using a 1031 Exchange when land is sold extends the time at which capital gains tax must be paid. The level of this benefit will vary among individuals depending upon the land's basis value and remaining time for which the asset is expected to be held. Often 1031 Exchanges result from the sale of cropland for development purposes.

In the market we expect equilibrium to exist among investments based on expected after tax earnings and risk. The market is composed of a wide range of investors and we expect the benefit of a tax sheltering provision to become capitalized into asset values. Interestingly it is expected that the market adjusts to a tax change rapidly when enacted, not gradually. This is important because 1031 provisions have been in place for some time.

What is the benefit of a 1031 Exchange? We can get some idea by examining the benefit to the seller for different capital gain rates and holding periods. I examined the benefit of a 1031 Exchange by comparing net after tax returns at the end of a 30-year time period; using the exchange part way through the period vs not using the exchange. I assumed a 7 percent return for land made up of a 3 percent dividend and 4 percent appreciation. Ordinary income tax was assumed to be 30 percent. All dividend returns were assumed to be reinvested for a 3 percent dividend level with no withdrawals. Two time assumptions were examined. One was a sale after 10 years and the second was a sale after 20 years. Also, five capital gains rates at year 30 were analyzed at which time the land investment was sold with no further reinvestment. The first capital gains tax rate is zero in that periodically it is suggested that capital gains should not be taxed. The current rate (.15) is examined as well as .2, .25, and .3. The last is the same as the assumption which was made for the ordinary income tax level. When not using the 1031 Exchange the capital gains rate at either year 10 or year 20 was assumed to be the current rate of .15. An initial investment of $1,000 was assumed. When the 1031 Exchange is not taken, capital gains at a mid-term sale reduce the reinvestment level.

The results are shown in Table 1. Clearly, the differences between using or not using the 1031 are not dramatic. This is particularly true in that the differences are calculated for year 30 and the decision point whether to use a 1031 Exchange is at year 10 or 20 respectively. Obviously, higher ending capital gains rates reduce net benefits in all cases. Differences are greatest when a sale occurs after 20 years, leaving only 10 years remaining. For example, not using the 1031 Exchange and paying capital gains at year 20 (at a .15 rate) results in a net return of $4,684 at year 30, if the capital gains rate at year 30 is zero. Using the 1031 Exchange at year 20 results in a $4,827 net. The opposite advantage occurs at an ending capital gains rate of .3. If capital gains rates are expected to be higher than .15 when the asset is finally liquidated, paying the tax at midpoint is a better alternative if the asset was held for a long period (20 years).

A tax shelter provision, when enacted would be recognized by landowners (and therefore the market) and any significant impacts would be expected to be rapidly incorporated rather than gradually incorporated. Thus, while a 1031 Exchange involves benefits as shown in Table 1, the size of the benefit does not appear to be of major importance when it is recognized that these differences are in "year 30" dollars. Of course, for some sellers in particular situations the tax savings at sale time will be viewed as significant. That benefit is particularly important if the capital gain is never taxed because it is expected to be held until death.

Finally, even if there are significant overall long-run tax shelter benefits from 1031 Exchanges, how 1031 Exchanges impacts the market for cropland is not clear. It can be questioned whether the benefit of the tax shelter is gained by the seller or the buyer. Because of the tax benefit accruing to the seller, perhaps the land market impact is negligible because the buyer can pay less for development land. In that case no net benefit accrues to the seller. Who receives the benefit or how the benefit is shared is a complex issue and can only be determined empirically. Our preliminary research suggests that the market for cropland has not increased from 1031 Exchanges.

Glenn A. Helmers, (402) 472-1788
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**Table 1. After Tax Values for the $1,000 Land Purchase at the End of 30 Years Using and Not Using the 1031 Exchange**

| | Sale Year 10 | | Sale Year 20 | |
|---|---|---|---|---|
| Year 30 Capital Gain Tax Rate | Using 1031 | Not Using 1031 | Using 1031 | Not Using 1031 |
| 0 | 4843 | 4614 | 4827 | 4684 |
| .15 | 4506 | 4373 | 4491 | 4565 |
| .20 | 4394 | 4293 | 4379 | 4526 |
| .25 | 4282 | 4212 | 4267 | 4487 |
| .30 | 4170 | 4132 | 4154 | 4447 |